

November 18, 2002

Mr. Raul Regalado, President and CEO  
Members of the Board of Commissioners  
Metropolitan Nashville Airport Authority  
One Terminal Drive, Suite 501  
Nashville, TN 37214

**Report of Internal Audit Section**

Dear Mr. Regalado and Board of Commission Members:

We have recently completed a review of certain derivative contracts executed by the Metropolitan Nashville Airport Authority (MNAA). This review was conducted at the request of the Director of Finance of the Metropolitan Government of Nashville and Davidson County.

Our objectives for this review included: (1) Conduct a detailed review of the risks associated with all interest rate swap contracts currently in place at MNAA, (2) Analyze the prudence of the current interest rate swap contracts, and (3) Develop recommendations for MNAA relative to any future interest rate swap contracts.

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In completing this review we retained the services of KPMG Investment Advisors, an affiliate of KPMG LLP, to work under our direction. KPMG issued a detail report of their analysis, findings, and recommendations, which is attached to this report.

### **Scope and Procedures**

This review was initiated in March, 2002 and focused on four derivative contracts as of June 30, 2002 as follows:

	<u>Notional Amount</u>
Sogen Swap	\$53,500,000
6.0% Knock-in Barrier Swaption	53,500,000
6.5% Knock-in Barrier Swaption	64,730,000
7.0% Knock-in Barrier Swaption	29,355,000

The notional amount reflects the amount of the underlying debt upon which the swap payments are to be based. These derivatives mature in 2015 through 2019.

The procedures performed by KPMG included:

- Reviewing any MNAA debt policies,
- Reviewing the terms and conditions of each swap contract,
- Assessing any analysis performed to evaluate swap contracts prior to execution,
- Modeling the financial aspects of each contract against various market conditions,
- Determining the financial and economic sensitivity to market changes, and
- Reviewing the risks associated with each swap contract.

### **Findings and Recommendations**

As a result of their review, KPMG issued the attached report detailing their analysis, findings, and recommendations. Early in their review, KPMG concluded that the risks associated with the Sogen Swap were minimal. As a result, most of their analysis focused on the three knock-in barrier swaptions, and the more significant matters noted in their report are primarily related to those derivative contracts.

KPMG found that the three knock-in barrier swaptions were complex derivative contracts that are speculative in nature. While KPMG had encountered basic interest rate swap derivatives in other airport reviews, they had not encountered speculative derivatives among their other airport clients as complex as those in place at MNAA. KPMG also concluded that the contracts were executed without sufficient independent analysis. While MNAA reviewed historic interest rates and concluded that there was little probability of interest rates staying above the barrier rates long enough to trigger an increase in the interest rates MNAA would have to pay, KPMG concluded that the contracts were priced under the assumption that there was a 40% chance that such an interest rate barrier breach would occur during the term of the contracts. If such a breach were to occur prior to 2010, KPMG concluded that it would likely have a materially negative impact on cash flow.

KPMG recommended that any future derivative contracts be independently analyzed prior to execution. Further, KPMG did not find that MNAA had a debt management strategy in place that integrated a debt policy and a derivative policy, and they recommended that such policies and an overall debt strategy be adopted before any derivative contracts are considered in the future.

The knock-in barrier swaption contracts and KPMG's analysis are complex, and their attached report addresses the contracts and analysis in detail and includes additional background on the nature of derivatives in Appendix III.

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Management's response to the audit recommendations is attached to this report. As part of their response, management included a probability analysis conducted by Deloitte & Touche. The Deloitte analysis concludes that the likelihood of interest rate barriers being breached was low – 10.11% and under at the time the transaction was entered - which supports MNAA's view that they expected to make money on the transaction. The Deloitte analysis would have been based on historic interest rate movements, and does not contradict KPMG's conclusion that the transaction was actually priced based on interest rate option movements at the time of the transaction that implied a 40% likelihood that the interest rate barriers would be breached. Further, the Deloitte analysis does not contradict KPMG's conclusion that the transaction itself was speculative in nature.

This report is intended for the information of the management of the Metropolitan Government of Nashville and Davidson County. This restriction is not intended to limit the distribution of this report, which is a matter of public record.

Internal Audit Section

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Internal Audit Manager

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